Allowance Method: Percentage of Net Credit Sales and Percentage of Receivables

by Sophia

WHAT'S COVERED

This tutorial will cover the allowance method using percentage of net credit and percentage of receivables.

Our discussion breaks down as follows:

1. Uncollectible Accounts: A Review

An uncollectible account is an accounts receivable that is unpaid and is written off as bad debts expense.

We need to recognize and record these uncollectible accounts and the amounts that are expected not to be collected from credit customers. So, if any customers made purchases on credit and we don't expect to collect on those sales, we need to record those uncollectible accounts.

Now, the allowance method is required for financial reporting. It helps us to achieve matching, so that we can match our bad debts expense with the period in which the uncollectible sale took place.

We can determine uncollectible accounts by using some common methods to help us calculate our uncollectible accounts, or our allowance.

We can use:

- Percentage of net credit sales
- Percentage of receivables
- Aging receivables.

Today we're going to focus on those first two.

2. Percentage of Net Credit Sales

Percentage of net credit sales refers to estimating the percent of credit sales made for which payment will not be received.

We can use several methods to make this estimate, such as industry standards, past experience, or any other logical method.

An income statement relationship is emphasized in the percentage of net credit sales method, because we're looking at sales in order to make our estimate to record our bad debts expense.

Again, this helps us achieve matching because we are matching that bad debts expense with the period in which that revenue took place.

Under the percentage of net credit sales method, the existing balance in our allowance account is not considered; we don't need to worry about any balance that is already in our allowance account. Instead, we can focus on our sales and our estimates for bad debt expense.

↗ EXAMPLE Suppose Company ABC estimates that 2% of their net credit sales will become uncollectible. We also know that net credit sales for 2012 were $100,000.

What is the estimated allowance?

Well, we take our net credit sales and multiply it by the percent uncollectible, our percentage estimate, to give us our allowance.

In this case, we take $100,000, which is our net credit sales, and multiply that by our estimate of 2%, to give us an allowance of $2,000.

Formula	Calculation
Net Credit Sales × %Uncollectible Allowance	$100,000 × 2% $2,000

For the journal entry, we know that we have a debit and a credit, so we're going to debit bad debt expense for $2,000 and credit allowance for uncollectible accounts for $2,000.

Debit	Bad Debt Expense	$2,000	
Credit	Allowance for Uncollectible Accounts		$2,000

This is an illustration of a calculation under the percentage of net credit sales, for recording the allowance.

3. Percentage of Receivables

Percentage of receivables is estimating percent of accounts receivable for which payment will not be collected. So, now we are focusing on the accounts receivable to create our estimate.

Just like with percentage of net credit sales, we use industry standards, past experience, or any other logical method to make our estimate.

In this case, since we're focusing on receivables, the relationship that is emphasized is the balance sheet. We are looking at accounts receivable to help us determine our allowance for uncollectible accounts, which are both balance sheet accounts.

Under the percentage of receivables method, the existing balance in the allowance account*is* considered. So, when we are performing our calculation, we need to make sure we take into account any balance that is already in the allowance account.

↱ EXAMPLE Let's consider the a similar example as above. Company ABC estimates that 2% of their accounts receivable will become uncollectible. We also know that the accounts receivable balance is $100,000.

What is the estimated allowance?

It's going be a similar calculation as what we performed before. We take our accounts receivable and multiply it by the percent uncollectible that we estimated to get to our allowance.

In this case, we take $100,000 and multiply it by 2% to get to $2,000, which is our allowance.

Formula	Calculation
Accounts Receivable × %Uncollectible Allowance	$100,000 × 2% $2,000

We also need to consider the balance in our allowance account. In this case, we're going to assume that the balance in the allowance account is $500.

This affects the journal entry in the following way. We're still going to have a bad debt expense, but in this case, it's only going to be for $1,500, and the credit is going to be allowance for uncollectible accounts for $1,500.

Debit	Bad Debt Expense	$1,500	
Credit	Allowance for Uncollectible Accounts		$1,500

This is because we have an existing balance of $500 in the allowance account, and we needed to get to that $2,000 that we calculated in our allowance. In order to get to that $2,000, we only needed to increase the allowance account $1,500.

This represents the slight difference and variation with calculating percentage of receivables.

SUMMARY

Today we began with a **review of uncollectible accounts**, which are recorded using the allowance

method. Note, the allowance method is required for financial reporting. We learned about two ways to record our allowance: calculating **percentage of net credit sales** and **percentage of receivables**.

Source: Adapted from Sophia instructor Evan McLaughlin.